

web.
✓ R.

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

California Rules of Court, rule 977(a), prohibits courts and parties from citing or relying on opinions not certified for publication or ordered published, except as specified by rule 977(b). This opinion has not been certified for publication or ordered published for purposes of rule 977.

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION FIVE

EDWARD P. FREIDBERG et al.,
Plaintiffs and Respondents,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

A106315

(San Francisco County
Super. Ct. No. 404182)

In this tax refund action, the trial court ruled that the Franchise Tax Board improperly disallowed several business deductions on a personal income tax return. The deductions were disallowed on the ground that the taxpayer's horse racing and breeding operations were a hobby, not a business. The trial court found that the taxpayer was primarily motivated by profit throughout the history of his horse activity and thus was entitled to the business deductions. The FTB challenges the superior court's jurisdiction, the evidentiary support for the court's findings, and the relief granted. We find no error and affirm.

BACKGROUND

Freidberg is a highly successful medical malpractice attorney. In 1974, he started buying Standardbred harness racing horses and promoting the sport of harness racing in Sacramento, California. He abandoned the promotional effort in 1976 and moved his operations to New Jersey, where Meadowlands Racetrack had recently become the

premiere harness racing venue in the world. One of Freidberg's horses, Whata Baron, cost Freidberg \$75,000 and earned \$250,000 in 1978 alone. Two other horses brought Freidberg \$700,000 and \$1 million in profits, respectively. In 1978, Sports Illustrated magazine called Freidberg and his wife the most successful new breeders at Meadowlands.

In 1979, Freidberg borrowed money to start a farm, where he hoped to hire out Whata Baron as a stud. By 1980, he had borrowed \$5,129,754 for his farm and breeding operations. At that time, the prime interest rate was 8 percent. By 1981, it had risen to almost 20 percent. The rise in interest rates not only increased Freidberg's debt burden, but also depressed the horse industry, reducing the value of Freidberg's horses and breeding services. Moreover, Whata Baron was not a successful stud.

Freidberg attempted to sell his farms in order to pay off his loans. To make his farms more marketable, he purchased a 25 percent interest in Cam Fella, a horse that had earned over \$1 million in racing, and thus obtained the right to stand Cam Fella on his farms as a stud. In 1985, Freidberg sold two of his farms for \$4.4 million to Dreamaire Stud. In 1986, however, Congress enacted the 1986 Tax Reform Act, which eliminated the ability of passive horse investors to offset their income by losses from their horse activity. The tax reform had a devastating impact on the horse industry. Dreamaire went bankrupt and its outstanding obligation to Freidberg for \$1.6 million was eventually discharged in bankruptcy.

In the late 1980's and the 1990's, Freidberg restructured his horse activity and reduced his expenses in an attempt to pay off his loans and make his remaining operations profitable. He anticipated substantial income from Cam Fella's stud fees, but the horse developed testicular cancer in about 1994 and eventually had to be gelded. Freidberg got out of the horse business in the late 1990's.

Freidberg grossed \$32 million from his horse activity between 1974 and 1994, but his net losses over that period were about \$7 million and the activity never turned a taxable profit. Although Freidberg obtained personal tax savings by offsetting his law

practice income with these losses, the millions of dollars of his own money that he spent far outstripped any tax savings.

The FTB audited Freidberg for the tax years 1985 and 1986 to determine whether the horse activity was a business driven by profit or a hobby where profit was not the primary motive. If the activity was a business, as Freidberg claimed, he was entitled to deduct expenses and losses from the activity on his personal income tax return, as he did. If the activity was a hobby, deductibility of expenses and losses was restricted and Freidberg's tax returns underreported his tax liability. (Compare 26 U.S.C. § 162 with § 183; see also Rev. & Tax. Code, §§ 17201, subd. (a); 17024.5.) At the conclusion of the audit in 1990, the FTB issued a no change letter and assessed no new taxes.

This case arises from a second audit initiated by the FTB in 1995, eventually encompassing the tax years 1990 to 1994. The FTB concluded that Freidberg's horse activity was a hobby in those years. Accordingly, it recalculated Freidberg's deductions under the hobby tax rules and assessed additional taxes and penalties. Freidberg protested the assessment on two grounds. First, he argued that he acted primarily with a profit motive throughout the history of the horse activity. Second, Freidberg argued that even if the horse activity was a hobby in the 1990's, he was entitled to take certain business deductions in the 1990's that were based on debt and losses incurred in the 1980's, when the horse activity was a business as recognized by the FTB no change letter. Freidberg made the same arguments throughout the administrative proceedings and in the trial court.

Following a protest hearing, the FTB upheld the auditor's analysis and assessment. Freidberg then appealed to the State Board of Equalization (SBE). The SBE concluded that the horse activity was a hobby in the tax years 1990 to 1994, but ruled, nevertheless, that Freidberg was entitled to carry forward net operating losses from earlier years and deduct those losses on his 1993 return. The SBE rejected Freidberg's argument that he was also entitled to deduct interest expenses and bad debt losses that were incurred in earlier years.

Based on the SBE's final ruling, the FTB issued notices of determination assessing additional taxes for the years 1991 to 1994. Freidberg worked out an installment plan with the FTB to pay the taxes plus interest by June 2001. He made payments through June 2001 and filed an administrative claim for refund with the FTB in July 2001. In October 2001 Freidberg made a final \$145 payment.¹ In December 2001, the FTB asked Freidberg for additional information supporting his refund claim. Freidberg responded that he had already provided the SBE with all of the relevant information. In February 2002, after six months had passed without a decision on his claim for refund, Freidberg filed his tax refund suit. Shortly thereafter, the FTB issued its decision denying the claim.

At trial, the FTB moved for summary judgment based on Freidberg's failure to exhaust administrative remedies. The court denied the motion. Following a nine-day bench trial, the court found that Freidberg was motivated primarily by profit throughout the history of his horse activity. The court awarded Freidberg the full amount of taxes and interest paid through June 2001.

DISCUSSION

Several of the FTB's procedural challenges to the trial court's decision arise from a mistake in Freidberg's administrative claim for refund, which suggested that Freidberg was seeking a tax refund based on deductions that had already been allowed by the FTB and the SBE. This mistake caused understandable confusion for the FTB (as well as this court). We conclude that Freidberg's mistake had no prejudicial effect on the FTB's consideration of Freidberg's refund claim, and it did not cause the trial court to award double deductions to Freidberg.

As to the core substantive issue in this case—whether Freidberg acted primarily with a profit motive throughout the history of his horse activity—the FTB's finding is amply supported by the record. We review the trial court's resolution of disputed factual

¹ The payment represented additional interest that accrued because of deficient and/or late installment payments.

issues under a substantial evidence standard. (*Winograd v. American Broadcasting Co.* (1998) 68 Cal.App.4th 624, 632.)

I. *Jurisdiction*

The FTB argues that the trial court lacked jurisdiction over Freidberg's tax refund suit on two grounds: failure to exhaust administrative remedies before filing his tax refund suit and failure to satisfy a requirement that the taxpayer pay all of the assessed taxes plus interest before filing a claim for refund. We reject both arguments.

A. *Exhaustion of Administrative Remedies*

Freidberg's limited response to the FTB's request for additional information regarding his claim for refund did not amount to a failure to exhaust because it did not deprive the Board of notice or a meaningful opportunity to respond to Freidberg's claims.

In his refund claim to the FTB, Freidberg renewed the argument made before the SBE that, even if he lacked a primary profit motive in the tax years 1990-1994, he was entitled to deductions based on losses or expenses incurred in earlier years when he was acting with a primary profit motive. Among the deductions he claimed under this theory was a deduction for net operating loss carryforwards in 1993. The SBE, however, had already allowed that deduction when it ruled on Freidberg's appeal. The deduction was reflected in the June 2000 Notices of Determination that quantified Freidberg's tax liability following the SBE appeal. Freidberg was only required to pay the amounts on those Notices of Determination. Because no additional taxes were assessed based on a disallowance of the net operating loss deduction, Freidberg's demand for the deduction was mistaken. Freidberg's mistake is the genesis of much confusion.

The FTB wrote to Freidberg requesting clarification "as to whether or not you are seeking additional Net Operating Losses that were generated in 1985 and 1986 . . . to be taken in the years of your claim" and if so "why weren't the Net Operating Losses addressed during the audit of those tax years, but rather now?" Freidberg replied that the requested information had been provided at the time of his appeal to the SBE. Freidberg

later explained that he included the net operating loss deduction in his claim for refund in an abundance of caution, in case the FTB challenged the SBE's ruling.

As mentioned, the FTB's motion for summary judgment was based on Freidberg's failure to exhaust by refusing to provide the information the Board requested. The trial court denied the motion and we affirm.

Exhaustion of administrative remedies by filing a claim for refund is a jurisdictional prerequisite to a tax refund suit. (Rev. & Tax. Code, §§ 19322, 19382; *Aronoff v. Franchise Tax Board* (1963) 60 Cal.2d 177, 181.) The taxing authority must be given an opportunity to determine matters of law and fact, even though its determination of such matters is subject to de novo judicial review. (*People v. West Publishing Co.* (1950) 35 Cal.2d 80, 88.) A failure to provide information the FTB needs in order to evaluate a claim for refund may amount to a failure to exhaust. (*Barnes v. State Board of Equalization* (1981) 118 Cal.App.3d 994, 1001-1002; *Duffy v. State Bd. of Equalization* (1984) 152 Cal.App.3d 1156, 1174.)

In *J. H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 986, we held that the administrative claim for refund requirement is a notice rather than a pleading requirement. The purpose of requiring a claim is served if the taxpayer's challenge to the tax assessment is set forth in the refund claim or can reasonably be ascertained therefrom. (*Id.* at p. 988.) The exhaustion requirement is satisfied if the FTB receives actual prior notice of the arguments the taxpayer raises in the tax refund action. (*Id.* at p. 986; see also *Jimmy Swaggart Ministries v. State Board of Equalization* (1988) 204 Cal.App.3d 1269, 1291.)

The purposes of the administrative claim requirement were served here. Read in its entirety, the claim for refund put the FTB on notice that Freidberg was seeking a refund for the additional taxes that were assessed following the SBE decision, based on the same arguments he made to the SBE.²

² On pages one and two of the refund claim, Freidberg lists the installment payments he made to pay the assessment imposed following the SBE appeal and on

Freidberg's failure to substantively respond to the FTB's inquiry is immaterial because the inquiry arose from a mistake in the refund claim that turned out to be irrelevant to Freidberg's actual claims. While it is unfortunate that Freidberg did not more carefully draft his refund claim, the error as well as Freidberg's failure to correct his mistake in his response to the Board's inquiry did not deny the FTB an opportunity to consider the issues. In a six-year administrative process before both the FTB and the SBE, Freidberg consistently made the arguments that formed the basis for the tax refund action and he provided voluminous information in support of his claims. The FTB had ample opportunity to consider the legal and factual issues Freidberg raised in both his refund claim and in his tax refund action.

B. *Full Payment of Taxes*

The trial court properly denied the FTB an opportunity to raise its eleventh-hour argument that the court lacked jurisdiction because Freidberg failed to pay all assessed taxes and interest before he filed his claim for refund. (See Rev. & Tax. Code, § 19382.) Although full payment is a jurisdictional prerequisite to a tax refund action, it does not affect the trial court's subject matter jurisdiction and thus it is subject to forfeiture. The FTB forfeited the argument by failing to raise it in a timely manner.

The FTB first raised the argument nearly two years after Freidberg filed his tax refund action, more than seven months after the conclusion of a nine-day bench trial, and only in the third round of post-trial briefing. It relied not on newly discovered evidence, but on its own records as evidentiary support.

The FTB argues that lack of subject matter jurisdiction cannot be waived or forfeited. While that is a faithful recitation of the legal principle, the issue of the full payment of tax prerequisite does not raise the spectre of fundamental subject matter jurisdiction. As the Supreme Court explains in the seminal case *Abelleira v. District Court of Appeal* (1941) 17 Cal.2d 280, 287, the term "jurisdiction" has been "used

page two he summarizes his legal arguments, which are the same arguments he made throughout the administrative proceedings.

continuously in a variety of situations.” In *Abelleira*, the Supreme Court drew a distinction between subject matter jurisdiction and “jurisdiction” in the broad sense of the term. (*Id.* at pp. 287-289.) “Lack of jurisdiction in its most fundamental or strict sense means an entire absence of power to hear or determine the case, an absence of authority over the *subject matter* or the parties.” (*Id.* at p. 288, emphasis added.) A court lacks jurisdiction in the broader sense of the term if, although it has “jurisdiction over the subject matter and the parties in the fundamental sense, it has no ‘jurisdiction’ (or power) to act except in a particular manner, or to give certain kinds of relief, or to act without the occurrence of certain procedural prerequisites.” (*Ibid.*) In other words, the court's power to act is limited.

Describing the the payment of taxes as a jurisdictional prerequisite to filing a claim does not necessarily mean that the court's fundamental subject matter jurisdiction is implicated. (Accord *Keiffer v. Bechtel Corp* (1998) 65 Cal.App.4th 893, 896-897.) Under *Abelleira, supra*, 17 Cal.2d 280, the tax payment requirement is jurisdictional in the broader sense of the term. It is a procedural prerequisite that, if not satisfied, deprives the court of the power to grant a tax refund. The cases cited by the FTB do not support a conclusion that fundamental subject matter jurisdiction is implicated here.

Because failure to prepay taxes before filing a tax refund suit is a jurisdictional defect in the broad sense of the term, it is subject to forfeiture. (*Green v. City of Oceanside* (1987) 194 Cal.App.3d 212, 220-222.) The instant case amply illustrates the fairness of such a rule. Despite the fact that the FTB always had in its possession information demonstrating that Freidberg had not fully paid all taxes and interest before filing his refund claim, the Board did not assert the jurisdictional defect until long after pretrial motions had been litigated, a lengthy trial on complex factual issues had been held, and most of the post-trial briefing had been completed. As in *Green*, it would be simply unfair to dismiss an action on exhaustion grounds long after the taxpayer had an opportunity to correct the error and after the court trial had been completed. (*Green*, at p. 222; cf. *J. H. McKnight Ranch, supra*, 110 Cal.App.4th at pp. 990-992 [FTB may be equitably estopped from arguing failure to exhaust in a tax refund action].)

The forfeiture rule applies even though statutory prerequisites to tax refund actions are backed by a constitutional mandate. The state Constitution authorizes taxpayers to file tax refund actions only in such manner as may be provided by the Legislature. (Cal. Const., art. XIII, § 32.) Statutory prerequisites to tax refund suits must be strictly enforced. However, when we hold that the issue is waived or forfeited, we do not change statutory requirements. It is the taxing authority's own conduct that relieves the taxpayer of statutory requirements. (Cf. *J. H. McKnight Ranch, supra*, 110 Cal.App.4th at pp. 990-992 [equitable estoppel].)

FTB cites authority for the principle of strict enforcement where courts have rejected judicially created exceptions to statutory requirements. (See *Patane v. Kiddoo* (1985) 167 Cal.App.3d 1207, 1214; *Shiseido Cosmetics (America) Ltd. v. Franchise Tax Bd.* (1991) 235 Cal.App.3d 478, 487-488.) *Patane* and *Shiseido* are distinguishable because had those courts recognized the futility exception to the requirement of exhaustion of administrative remedies, they would have usurped the Legislature's constitutionally mandated authority to determine what steps must be exhausted before the state may be sued.

By holding that the FTB forfeited its full payment defense, we do not impinge on the Legislature's authority to proscribe the manner in which tax refund actions may be brought. We conclude only that the state's own conduct in belatedly raising the issue relieves the taxpayer of the exhaustion requirement.

II. *Profit Motive*

The trial court's finding that Freidberg acted with a profit motive throughout the pertinent history of his horse activity is supported by substantial evidence. Therefore, we need not address the FTB's challenge to the court's alternative holding that the Board was estopped by its 1990 no change letter from arguing that Freidberg lacked a profit motive in 1985 and 1986. Similarly, we need not address the FTB's argument that the trial court erred when it concluded that the SBE's allowance of the net operating loss

deduction in 1993 implied a finding that the horse activity was a for-profit business in 1987 and 1988, when those losses were incurred.

The trial court concluded “that profit was the primary, predominant, and principal purpose for which Friedberg engaged in the horse activity.” The trial court's extensive analysis covered the entire history of Friedberg's horse activities from 1974 to 1994. Reviewing evidence of Friedberg's profit motive, the trial court referred to Friedberg's 1970's purchases of horses that went on to generate profits; his financial difficulties in the 1980's that were caused by factors beyond his control, including a substantial rise in interest rates, the effect of the 1986 Tax Reform Act on the horse industry, Whata Baron's failure as a stud, and Dreamaire's bankruptcy; and his continuing efforts in the late 1980's and early 1990's to “[fight] through this financial quagmire” and restructure the business to make it profitable, even though his interest expenses exceeded the tax savings he derived from the activity. The trial court made extensive factual findings, and wrote a carefully reasoned, thorough analysis of the issue, applying the nine-factor test set forth in Treasury Department regulations to the facts. The court separately considered each factor and harmonized its conclusions with case law on the issue. We conclude that the court's findings are supported by substantial evidence.³

III. *Trial Court Award*

The FTB challenges the relief granted to Freidberg on several grounds. First, the Board argues that the court erroneously awarded double deductions to Freidberg. That is, it argues that the court awarded a tax refund based on deductions that had already been

³ The FTB claims the trial court erred in refusing to take judicial notice of tax laws in jurisdictions where Freidberg conducted his horse activity. The Board argues that Freidberg's admitted failure to file tax returns in those districts would have been illegal if the horse activity was a business, and thus his failure to file those returns demonstrated his belief the horse activity was not a business. Even assuming Freidberg was required to file tax returns in those jurisdictions if his horse activity was a business, that he failed to do so, and that the trial court erred in failing to consider the evidence, the error was harmless. It is not reasonably probable that Freidberg's failure to file tax returns in those jurisdictions would have persuaded the court that Freidberg lacked a profit motive, in light of the voluminous other evidence the court cited to support its finding.

allowed by the FTB and the SBE. This argument arises from the mistake in Freidberg's claim for refund discussed *ante* and it has no merit. Second, the FTB argues that trial court was limited to awarding a tax refund based on deductions that were listed in Freidberg's claim for refund. Since Freidberg listed some deductions that had already been allowed, the Board argues, the court erred by awarding his entire request for relief. This argument also arises from the mistake in the administrative claim. It became moot when the trial court found that Freidberg acted with a profit motive throughout the pertinent history of his horse activity. Third, the FTB argues that Freidberg failed to present evidence substantiating his claimed deductions. We conclude the record contains substantial evidence establishing Freidberg's entitlement to deductions. Finally, the FTB argues that the trial court misapplied tax laws and regulations when it allowed the deductions. These arguments relate only to deductions for net operating losses and for interest expenses incurred in the 1980's. No net operating losses were at issue in this case, and the Board's legal argument regarding the interest expense was rendered moot by the trial court's finding that Freidberg had a primary profit motive throughout the pertinent history of his horse activity.

A. *Double Deductions*

In part I.A, *ante*, we noted that Freidberg mistakenly included in his claim for refund a demand for a net operating loss deduction that had already been allowed by the SBE. In the same part of his refund claim, Freidberg also demanded interest expense deductions that had already been allowed by the FTB. Presumably, Freidberg intended to demand the interest expense deductions that had been disallowed by the FTB, but he made a mistake. In addition to these net operating loss and interest expense deductions, the refund claim also demanded a bad debt loss deduction that had been disallowed by the FTB and the SBE (and thus was properly included in the refund claim).

The FTB's argument that the trial court awarded double deductions to Freidberg is based on this error in his claim for refund. The mistake, however, pertains to Freidberg's second, *alternative* argument that he was entitled to a *partial* refund in the event the FTB

(or the court) found he lacked a primary profit motive in the 1990's. This argument became irrelevant when the trial court found that Freidberg acted with a primary profit motive throughout the pertinent history of his horse activity. On pages one and two of his refund claim, Freidberg demanded a *full* refund based on his *principal* argument that he acted with a primary profit motive during all relevant years. He quantified that full refund by listing the installment payments he had made. The trial court awarded the sum of those installment payments, \$266,451.55, plus interest. That is, the court awarded the amount of tax assessed on the June 2000 Notices of Determination, plus interest, and the June 2000 Notices of Determination were based only on tax deductions that were *disallowed* by the FTB and the SBE. Freidberg did not benefit from any double deductions.

B. *Failure to List Deductions in Claim for Refund*

Freidberg's erroneous demand for deductions that had been allowed by the FTB and the SBE, rather than deductions that had been disallowed, did not bar the court from awarding him full relief.

A claim for refund must state the specific grounds for the claim and a taxpayer may file a tax refund action only on the grounds set forth in the claim for refund. (Rev. & Tax. Code, §§ 19322, 19382, 19385; see also Cal. Code Regs., tit. 18, § 19322.) Freidberg, however, made two arguments in his refund claim. He prevailed on his first argument that he was entitled to a full refund because he acted with a primary profit motive throughout the pertinent history of his horse activity. Therefore any errors in his second argument, that even if he lacked a primary profit motive in the 1990's he was entitled to deduct certain expenses and losses incurred in years when he did have such a motive, were irrelevant. The FTB cites no authority requiring Freidberg to list the disallowed deductions that underlay his claim for a full refund. He stated the ground for his claim (that the horse activity was always a business); that is all the statutes require.

C. *Substantiation of Deductions*

We assume for purposes of argument that Freidberg bore the burden not only of proving that the taxing authorities' reasons for disallowing his deductions were incorrect, but also of proving his entitlement to the disallowed deductions. (See *Honeywell, Inc. v. State Board of Equalization* (1982) 128 Cal.App.3d 739, 744.) In other words, we assume he needed to substantiate those deductions in his tax refund action with evidence that he actually incurred the expenses or losses he sought to deduct.

Regarding Freidberg's bad debt losses based on the Dreamaire bankruptcy, the FTB questions Freidberg's evidence, arguing that the entity to which Freidberg loaned money was not the same entity that went bankrupt. Substantial evidence supported the trial court's conclusion that he met this burden. Freidberg produced evidence that G&B Farms, Inc. took out a \$2.6 million note when it purchased Freidberg's farms in June 1985. He testified that in structuring the transaction G&B Farms assigned the loan to Dreamaire Stud, a limited partnership for which G&B Farms was the general partner, and that Freidberg agreed to the assignment. The trial record contains a mortgage note dated February 1986, which committed Dreamaire Stud to pay Freidberg \$1,832,443.46. The note was signed on behalf of "Dreamaire Stud (A Limited Partnership) By G&B Farms, Inc., General Partner." The record also contains a default judgment Freidberg secured against Dreamaire Stud on the mortgage note, and a bankruptcy court filing in the case of *In re: Dreamaire Stud, a limited partnership of the State of New Jersey*, in which Freidberg attempted to recover on Dreamaire's debt following the sale of the farms. This evidence sufficiently demonstrates that Freidberg suffered a bad debt loss due to the bankruptcy of Dreamaire.

Regarding the remaining deductions, Freidberg introduced evidence of his business expenses and operating losses through the testimony of his accountant, Paul Liguori, and through documentary exhibits. The accountant testified that those expenses and losses formed the basis of Freidberg's claimed deductions. This evidence substantially supported the claimed deductions.

D. *Consistency with Tax Laws and Regulations*

The FTB argues the trial court misapplied tax laws and regulations to the facts of the case when it awarded deductions for net operating losses and interest expenses. The Board's arguments regarding net operating loss deductions are irrelevant because no net operating loss deductions were at issue in the court action. The Board's arguments regarding interest expenses deductions are irrelevant because the arguments apply to the ability of taxpayers to take interest expenses as a business deduction in a year when an activity was a hobby on the ground that the underlying loans were incurred when the activity was a business. When the trial court found that Freidberg had a profit motive throughout the pertinent history of his horse activity, this argument became moot.

DISPOSITION

The judgment is affirmed. Costs on appeal are awarded to respondent.

GEMELLO, J.

We concur.

STEVENS, Acting P. J.

SIMONS, J.